More fundamentally, the *Order* errs because the 12.95% cost of capital it adopts fails to account for the regulatory risks that arise from providing UNEs. AT&T/WorldCom do not dispute this omission. Instead, they claim that the *Triennial Review Order* only required the cost of capital to take into account the regulatory risk associated with the provision of new services. AT&T/WCom Opp. at 24-25. While the *Triennial Review Order* specifically acknowledges that a TELRIC cost of capital must take into account "any unique risks (above and beyond . . . competitive risks . . .) associated with new services that might be provided over certain types of facilities," *Triennial Review Order* ¶ 683, there is no basis to conclude that all *other* regulatory risks can be ignored. It would make no sense to consider the risks associated with new services provided over UNEs, while disregarding the risks inherent in the provision of UNEs themselves. Indeed, the Commission itself has explained to the Supreme Court that the cost of capital must reflect all the "risks associated with the regulatory regime to which a firm [providing UNEs] is subject."[48]

Accounting for the regulatory risks inherent in providing UNEs also accords with well-established economic principles. As Verizon VA witnesses Dr. Shelanski, Dr. Vander Weide, and Professor Hausman all explained in their testimony, a proper cost of capital must take into account the regulatory risks of the UNE regime and of TELRIC pricing.[49] Failure to do so will "reduce artificially the value of the [use of the] incumbent LEC network and send improper

---

[48] Reply Brief for Petitioners United States and the FCC at 12 n.8, *Verizon Communications, Inc. v. FCC*, 535 U.S. 467 (Nos. 00-511 *et al.*) (2001) ("FCC Reply Br.").

[49] Verizon Virginia Inc. Direct Testimony of Dr. Howard Shelanski at 12-14, 30-31 (July 31, 2001) ("VZ-VA Ex. 101"); Verizon Virginia Inc. Direct Testimony of Dr. James Vander Weide at 5, 10, 39-43 (July 31, 2001) ("VZ-VA Ex. 104"); Verizon Virginia Inc. Rebuttal Testimony of Dr. James Vander Weide at 3-4, 30-31 (Aug. 27, 2001) ("VZ-VA Ex. 112"); Verizon Virginia Inc. Surrebuttal Testimony of Dr. James Vander Weide at 11-12, 20-22, 29-30 (Sept. 21, 2001) ("VZ-VA Ex. 118").

pricing signals to competitors" and thereby "discourage competitive LECs from investing in their own facilities." *Triennial Review Order* ¶ 682.

Significantly, neither the *Order* nor AT&T/WorldCom deny that the UNE regime presents significant regulatory risks, such as the risk that CLECs can cancel UNE leases at any time and move to alternative facilities or technologies. Instead, they claim that Verizon VA "waive[d]" the issue. AT&T/WCom Opp. at 22-23. They are wrong. Verizon VA presented testimony specifically noting that a provider of UNEs faces unique regulatory risks that must be compensated by UNE prices. In fact, this point was made at length by Dr. Shelanski, Dr. Vander Weide, and Dr. Hausman.[50/] And, while Verizon VA did not include a specific risk premium in its initial cost of capital to account for these added risks at the time the initial cost studies were completed, these witnesses explained that the initial cost of capital proposal would have to be adjusted to reflect these risks. Professor Hausman also offered a calculation of one way to account for these risks in his testimony. *See* VZ-VA Ex. 111 at 18-19 (proposing markup factors). In addition, Verizon VA submitted supplemental evidence that showed that the risks of providing UNEs are similar to the risks inherent in cancelable operating leases because CLECs are generally free to terminate their use of a particular element or of UNEs at any time and instead move to alternative facilities or technologies, leaving the incumbent's asset to sit idle. Moreover, even if CLECs continue to use the incumbent's UNEs, they are able to "cancel" their existing UNE leases and renew them at the lower rates that are set every few years based on new hypothetical network assumptions. Verizon VA's supplemental evidence showed that, applying a well-accepted methodology commonly used to value similar options in financial markets, the

[50/] *See* Verizon Virginia Inc. Rebuttal Testimony of Dr. Jerry Hausman at 3-4 (Aug. 27, 2001) ("VZ-VA Ex. 111"); VZ-VA Ex. 101 at 30-31; VZ-VA Ex. 104 at 40-43; VZ-VA Ex. 112 at 3-4, 30-31; VA-VZ Ex. 118 at 20-22.

cost of capital used to set UNE prices in this case should include a 5.41% risk premium. VZ-VA Proffer at 14-17. The Bureau's failure to consider this directly relevant evidence was plain error, and its decision led to a cost of capital that does not, as the Commission's precedent requires, account for all relevant risks.[51]

Finally, as Verizon VA explained in its application for review, the *Order* also errs in relying on the Capital Asset Pricing Model ("CAPM") instead of Verizon VA's single-stage Discounted Cash Flow ("DCF") model. VZ-VA AFR at 49-50. Although AT&T/WorldCom suggest that Verizon VA somehow was "not aggrieved" by that choice, Verizon VA clearly is aggrieved by the rejection of its single-stage DCF model in favor of a cost of equity estimate generated by the CAPM: the CAPM is uniquely sensitive to changes in interest rates, and therefore use of this model will create substantial fluctuations in the cost of capital, and the particular cost of capital set at any time will be an accident of timing. Indeed, AT&T/WorldCom now agree that the CAPM should not have been used because it "has not been, and cannot be, fully tested to determine 'whether it fits the facts.'" AT&T AFR at 8 n.4.

As Verizon VA demonstrated in its opposition to AT&T's and WorldCom's applications for review, it would have been far more appropriate to select Verizon VA's proposed single-stage DCF model instead of AT&T/WorldCom's three-stage model. VZ-VA Opp. at 12-15. Simply put, AT&T/WorldCom's model produces illogical results: it generates a *lower* cost of equity for *higher* risk companies, and its "pick and choose" patchwork of growth rates is demonstrably unrelated to the growth assumptions investors use to value companies. *See id.* at

[51] *See, e.g., United Mine Workers of Am. v. Dole*, 870 F.2d 662, 673 (D.C. Cir. 1989) (failure to supplement the record may raise serious doubts "about whether the agency chose properly from the various alternatives open to it"); *see also Radio-Television News Dirs. Ass'n v. FCC*, 184 F.3d 872, 888 (D.C. Cir. 1999) ("The FCC retains discretion to . . . reopen the record, to ensure that it fully accounts for relevant factual and legal developments . . . .").

13-14. By contrast, Verizon VA's model results in a highly significant correlation between growth rates and stock prices, indicating that this approach accurately reflects the way investors value stocks. *See* VZ-VA Ex. 192. Moreover, as the *Order* itself notes, the "constant growth DCF model has been widely accepted by regulators for many years," and the Commission itself used this model to derive the 11.25% cost of capital it has stated should be the starting point for determining a TELRIC cost of capital. *Order* ¶ 73 n.224. Thus, while the *Order* is right to reject AT&T/WorldCom's three-stage DCF model, it should have adopted Verizon VA's DCF model rather than the CAPM.

B. The *Order* Should Have Adopted Depreciation Lives Based on GAAP.

Verizon VA's proposed GAAP depreciation lives are accurate and forward-looking, and the *Order* should have adopted them rather than the outdated regulatory depreciation lives. That result was required by the Commission's fundamental requirement, reiterated in the *Triennial Review Order*, that TELRIC depreciation lives "should reflect any factors that would cause a decline in asset values, such as competition or advances in technology." *Triennial Review Order* ¶ 685. Verizon VA's GAAP lives, which are regularly reset and are specifically designed to account for such factors, comply with this principle. In contrast, the outdated lives adopted by the *Order* do not.

AT&T/WorldCom argue that the *Triennial Review Order* does not mandate the adoption of financial lives, but instead "leav[es] the choice of asset lives to the discretion of state commissions based on the best evidence of record." AT&T/WCom Opp. at 26. But in this case, Verizon VA's GAAP lives are the best, and indeed the only, "evidence of record" that "reflects the actual useful life of an asset that would be anticipated in a competitive market." *Triennial Review Order* ¶ 688. GAAP lives reflect the best available estimate of the effect of existing and future competitive conditions on economic lives. Of course, even a GAAP analysis overstates the appropriate lives for use in the hypercompetitive TELRIC world because GAAP lives account only for actual anticipated competition, not the hypothetical perfect competition required in a TELRIC world. Nor can GAAP lives ensure recovery where rates are reset every few years. Indeed, the Commission's own staff recently concluded that, "if investment costs are falling over time, and the period between TELRIC price adjustments is shorter than asset lives, then traditional TELRIC pricing will not permit incumbents to recover the cost of their investment."[52] It therefore clearly made no sense for the *Order* to adopt lives *shorter* than Verizon VA's GAAP lives.

As Verizon VA demonstrated, its GAAP lives, which are the same lives it uses for financial accounting purposes, are intrinsically forward-looking as well as accurate. GAAP lives are designed to provide the most accurate estimate of an asset's economic life based on current information. Thus, GAAP lives specifically account for technological changes, competition, and other factors that may decrease the period during which an asset will produce economic value. *See, e.g.*, Verizon Virginia Direct Testimony of Allen E. Sovereign at 10-11 (July 31, 2001) ("VZ-VA Ex. 105"). Accordingly, GAAP lives are regularly revised — often on an annual or even more frequent basis — to ensure that they account for the most updated information. *See,*

[52] David M. Mandy & William W. Sharkey, "Dynamic Pricing and Investment from Static Proxy Models," FCC, Office of Strategic Planning and Policy, OSP Working Paper Series No. 40, at 1 (Sept. 2003). AT&T/WorldCom attempt to downplay the Working Paper's conclusions as unrelated to whether to adopt GAAP lives. AT&T/WCom Opp. at 30 n.28. But the recovery shortfall described in the Working Paper will be larger to the extent regulatory lives are prescribed. Because those regulatory lives are longer than GAAP lives, the gap between the asset lives and the time when TELRIC prices are adjusted would be longer and the shortfall therefore larger.

e.g., Verizon Virginia Direct Testimony of Dr. John Lacey at 4 (July 31, 2002) ("VZ-VA Ex. 105").

Not surprisingly, then, Verizon VA's GAAP lives are well within the range of other current estimates of telecommunications asset lives. In fact, Verizon VA's GAAP lives are significantly *longer* than those used in AT&T's financial reports: for example, AT&T's 1999 annual report states that the useful life of network equipment (for both local and long distance service) ranges from 3 to 15 years, as compared to Verizon VA's useful life of 9 to 50 years. *See* Sovereign Direct at 12; Tr. at 3263-64 (Lee). Verizon VA's GAAP lives are comparable to those used by WorldCom as well. *See* VZ-VA Ex. 106 at 13 (noting that WorldCom's stated depreciation life for network equipment is approximately ten years).

AT&T/WorldCom nonetheless contend that "Verizon failed to muster any 'specific evidence' to support its assertion that recent technological or competitive developments require even shorter lives." AT&T/WCom Opp. at 28. But this argument makes no sense: it is a *requirement* of GAAP that factors such as technological and competitive developments be taken into consideration, and Verizon VA's proposed lives "are in fact compliant with GAAP." *Order* ¶ 116. As Verizon VA explained in its application for review, Verizon VA is required by *law* to comply with GAAP in its securities filings, which are certified by outside auditors. *See* VZ-VA AFR at 53. No additional evidence that Verizon VA's lives are GAAP-compliant should be necessary.

AT&T/WorldCom next argue that Verizon VA's GAAP lives are too short. They insist that GAAP lives are "biased towards the low (shorter) side because they are driven by corporate objectives, including the objective of protecting shareholders, and by the GAAP principle of conservatism, which encourages the accountant to err on the side of overstating costs for financial reporting when there is uncertainty about their precise level." AT&T/WCom Opp. at 28-29. Notably, the *Order* does *not* base its decision on the CLECs' arguments about GAAP's alleged conservatism; in fact, other than merely acknowledging that the CLECs make this argument, *see Order* ¶ 111, the *Order* never mentions it at all. And in any event, the CLECs have it backwards. As Verizon VA witness Dr. Lacey explained, shorter lives produce higher expenses, lower net income, and lower asset values, all of which may serve to *lower* stock prices rather than raise them. Shorter lives could also be a concern to creditors, causing them to raise the interest rates they charge the company. *See* VZ-VA Ex. 105 at 12-13; Verizon Virginia Surrebuttal Testimony of Dr. John Lacey at 6-7 (Sept. 21, 2001) ("VZ-VA Ex. 119"). Thus, Verizon VA would not have any interest in *understating* depreciation lives. And since Verizon VA uses its GAAP depreciation lives for *all* its operations and in a variety of contexts outside of UNE pricing, the possibility that its lives *might* be adopted in a UNE rate case simply would not provide Verizon VA with an incentive to adopt shorter depreciation lives across the board.

Nor is there anything to AT&T/WorldCom's assertion that GAAP lives are based on the "principle of conservatism." As Verizon VA showed, the CLECs' argument is outdated: Verizon VA's witness Dr. Lacey, who served on the committee that established GAAP and is a co-author of some of the GAAP principles, explained that in 1993, the Accounting Standards Executive Committee specifically rescinded the standard that implied that a conservative bias might be acceptable. Tr. at 3308 (Lacey). As Dr. Lacey demonstrated, conservatism is no longer included in the "hierarchy of accounting qualities" on which accounting standards are based. Tr. at 3308 (Lacey); VZ-VA Ex. 119 at 3. Indeed, Dr. Lacey explained that this change was made in order to ensure that application of GAAP produced its ultimate goal: the "right answer . . . an unbiased answer, our best answer." Tr. at 3311-12 (Lacey). AT&T/WorldCom's

reliance on outdated cases that fail to acknowledge the revisions to GAAP, *see* AT&T/WCom Opp. at 29-30, cannot change the fact that accountants responsible for applying GAAP must do so in keeping with current GAAP requirements, which compel accuracy.

There was accordingly no reason for the *Order* to reject Verizon VA's GAAP lives. By contrast, there was ample reason the *Order* should *not* have adopted outdated regulatory lives based on ranges the Commission prescribed in 1994 and updated in 1999. Those lives simply cannot qualify as "forward-looking." AT&T/WorldCom attempt to defend the regulatory lives as reflecting "a rigorous application of forward-looking principles by the Commission, including a 'detailed analysis of each carrier's most recent retirement patterns, the carriers' plans, and the current technological developments and trends.'" AT&T/WCom Opp. at 27 (citation omitted). But the Commission conducted that analysis *nine years ago*, before the passage of the Act and in the context of an entirely different regulatory regime, and the factors it considered have been long since superceded. And while AT&T/WorldCom claim that the Commission "reaffirmed" in 1999 that its lives were forward-looking, AT&T/WCom Opp. at 27, *that* determination is itself four years old. The telecommunications industry has undergone overwhelming competitive and technological developments over the past four years: the explosion of the Internet, the rise in local competition, the increasing substitution of wireless for wireline lines, and the growth in non-traditional sources of competition such as e-mail and instant messaging are all phenomena that developed over that time period. Verizon VA's GAAP lives can and do account for such developments, as well as those that are expected in the foreseeable future today. Regulatory lives that were set in the past cannot. The Commission should reverse the *Order* and adopt Verizon VA's GAAP lives.

C. The *Order* Should Have Adopted the Uncollectible Rate Proposed in Verizon VA's Supplemental Evidence.

The *Order's* failure to consider the accurate and updated uncollectibles data submitted by Verizon VA results in a drastic understatement of costs. *See* VZ-VA AFR at 54-55. Both the Commission and AT&T have recognized that rates should be set at a level sufficient to compensate carriers for any charges that cannot be collected.[53/] Because Verizon VA had limited experience with providing UNEs at the time its initial studies were performed, it used a proxy uncollectible figure based on its experience providing access and related services. But Verizon VA's supplemental evidence demonstrates that the uncollectible rate for the provision of UNEs is more than *45* times higher than the proxy figure used in its initial studies. *See id.* The Commission itself has recognized that the uncollectible rate going forward will be many times the historical access proxy rates (on the order of 4% to 5%) even for more stable lines of business.[54/] The *Order* clearly errs by refusing to consider Verizon VA's updated uncollectibles evidence, and the Commission should reverse that determination.

AT&T/WorldCom fail to offer any reason that Verizon VA's evidence on uncollectibles was properly ignored. Contrary to AT&T/WorldCom's assertions, AT&T/WCom Opp. at 37,

---

53/ *See* Policy Statement, *In the Matter of Verizon Petition for Emergency Declaration and Other Relief*, 17 FCC Rcd 26884, 26889 ¶ 9 (2002) ("the Commission's ratemaking policies for incumbent LECs also account for interstate uncollectibles and provide for their recovery through interstate access charges"); *see also* Letter from James W. Cicconi, General Counsel and Executive Vice President, Law & Government Affairs, AT&T Corp., to Honorable Michael Powell, Chairman, Attachment at pp. 1-2 (July 26, 2002) ("If Verizon believes that the recent bankruptcies of WorldCom and other CLECs warrant a higher allowance than previously approved, Verizon is free to ask state regulators to reopen its UNE prices so that the allowance for uncollectibles may be increased going forward.").

54/ Wireline Competition Bureau Staff Study of Alternative Contribution Methodologies, attachment to "Commission Seeks Comment on Staff Study Regarding Alternative Contribution Methodologies," Public Notice, FCC 03-31, at 5-8 (rel. Feb. 26, 2003) ("Staff Study") (assuming uncollectible rates of 4-5%).

Verizon VA's evidence appropriately reflects the long run rate of uncollectibles. The local telecommunications market is only becoming more volatile, and, as new entrants to the local service market, CLECs — particularly those that rely on UNEs rather than making long term investments in their own facilities — inevitably will have a higher rate of default than established firms in a more stable market. As Verizon VA explained, in the last seven years, more than 140 CLECs in Verizon's service areas have filed for bankruptcy and, of those, more than 50 have gone out of business. *See* Garzillo Decl. ¶ 16 (attached as Ex. A to Verizon Virginia's Motion for Stay (Sept. 29, 2003)).[55] Indeed, the trend of increased uncollectibles is evident throughout the telecommunications industry. For example, the uncollectibles for carriers reporting on ARMIS 43-01 (mainly mid-and larger-size ILECs) rose to more than $2.63 billion in 2001 — an increase of more than 51% over the prior year alone. *See* Verizon Virginia's Submission of Additional Record Evidence at 5 (Sept. 13, 2002).

AT&T/WorldCom's assertions that Verizon VA could decrease the uncollectible rate by "enforc[ing] the existing rules governing security deposits and advance payments from those CLECs that prove unable or unwilling to pay legitimate Verizon charges," AT&T/WCom Opp. at 38, miss the point. Verizon VA has every incentive to take advantage of these types of

---

55/ *See also* Varun Grover and Khawaja Saeed, *The Telecommunication Industry Revisted - the Changing Pattern of Partnerships*, Communications of the ACM, July 1, 2003 ("The [telecommunications industry] seems chaotic with valuations of telecom companies dropping . . . and no consistent view of the direction of the structural changes taking place. . . ."); Sandra Ward, *Stunted Growth: A Team of Tech-Telecom Specialists Sees More Static Ahead For Investors*, Barron's Online (Feb. 25, 2002) ("What concerns us is that this could be a dynamic where overcapacity continues to exist. It could be like the steel industry, where companies go into bankruptcy, restructure, come back and lower prices, and still find themselves not making it." (quoting industry analyst Scott Cleland)); Roger Crockett, *End of the Telecom Turmoil?*, Business Week Online, Aug. 22, 2002 ("Analyst Glenn A. Waldorf of UBS Warburg thinks that every telecom upstart [i.e., CLEC], except Time Warner Telecom, will have to restructure its debt, in most cases by going the Chapter 11 route.").

protections and already does so. Indeed, it has requested that the Commission impose even more rigorous protections to help incumbents guard against increased uncollectible charges from CLECs that declare bankruptcy.[56/] But despite its vigorous attempts to collect what it is owed, Verizon VA's uncollectibles have increased. *See* Verizon Virginia's Submission of Additional Record Evidence at 5. The CLECs' suggestion that Verizon VA is somehow "inefficient" in its use of these security arrangements is both ironic and hypocritical: AT&T itself forcefully *resists* the inclusion of such protections when negotiating interconnection agreements with Verizon.[57/]

Finally, the *Order* compounds the underrecovery caused by its refusal to consider Verizon VA's updated uncollectibles evidence by prohibiting Verizon VA from collecting disconnect charges at the time of connection. Although the *Order* claims that Verizon VA could account for any shortfall in recovery through its uncollectibles factor, it does not even propose its own upward adjustment to Verizon VA's uncollectibles figure. *See Order* ¶ 598.

Like AT&T/WorldCom's substantive objections to Verizon VA's uncollectibles evidence, their procedural criticisms of this evidence are meritless. AT&T/WorldCom claim that Verizon VA somehow "waived" its right to have this evidence considered because it was not presented until after the close of the record. AT&T/WCom Opp. at 35-37. But this ignores the fact that the Bureau had both the authority and the obligation to consider this critical and directly

---

56/ *See* Policy Statement, *Verizon Petition for Emergency Declaratory and Other Relief*, 17 FCC Rcd 26884 (2002).

57/ *See, e.g.*, Panel Direct Testimony of AT&T Communications of New Jersey, L.P. *et al.*, *Application of AT&T Communications of NJ, L.P., TCG Delaware Valley, Inc. and Teleport Communications of New York Petition for Arbitration of Interconnection Rates, Terms and Conditions and Related Arrangements with Verizon New Jersey Inc. Pursuant to Section 252(b) of the Telecommunications Act of 1996*, BPU Docket No. TO00110893, at 198-201 (N.J. Bd. Of Pub. Utils. Feb. 25, 2003) (arguing against inclusion of advance payment provision in interconnection agreement).

relevant evidence in light of marketplace and legal developments since the record in this case closed.[58] Indeed, the Commission's rules would have permitted the Bureau to consider this evidence on reconsideration: it makes no sense, therefore, to suggest that the Bureau was barred from doing so when Verizon VA presented this evidence almost one year before the decision was issued.[59] *See* 47 C.F.R. § 1.106(b)(2)(i).

AT&T/WorldCom's claims that Verizon VA is attempting to selectively reopen the record only with respect to issues that are favorable to Verizon VA, AT&T/WCom Opp. at 36, 38-39, are simply untrue. Verizon VA specifically and repeatedly requested that *all* parties be permitted to supplement the record with evidence of significant new developments.[60]

AT&T/WorldCom's objections to Verizon VA's supposed "piecemeal reopening of the record" are further undermined by AT&T/WorldCom's defense of the *Order's* decision to permit *the CLECs* to selectively supplement the record with respect to non-recurring costs. As discussed below, the *Order* permits AT&T/WorldCom to introduce new evidence concerning work times and occurrence factors for various non-recurring tasks that were not included in AT&T/WorldCom's non-recurring studies. AT&T/WorldCom defend this decision on the

---

[58] *See, e.g.*, *United Mine Workers*, 870 F.2d at 673 (failure to supplement the record may raise serious doubts "about whether the agency chose properly from the various alternatives open to it"); *see also Radio-Television News Dirs. Ass'n*, 184 F.3d at 888 ("The FCC retains discretion to . . . reopen the record, to ensure that it fully accounts for relevant factual and legal developments.").

[59] For the same reason, AT&T/WorldCom's suggestion that consideration of Verizon VA's evidence would have delayed the proceeding, AT&T/WCom Opp. at 36, is incorrect. Clearly, one year would have been more than enough time for the parties to supplement the record.

[60] *See, e.g.*, Verizon Virginia Inc.'s Motion to Permit Parties to Supplement the Record at 1 (Nov. 22, 2002); Reply of Verizon Virginia Inc. to Opposition of WorldCom Inc. and AT&T Communications, Inc. to Verizon Virginia Inc.'s Motion to Permit Parties to Supplement the Record at 1 (Dec. 16, 2002).

ground that Verizon VA will have an opportunity to respond to the new evidence AT&T/WorldCom introduce. AT&T/WCom Opp. at 88-89 & n.103. But, of course, AT&T/WorldCom would have had a full opportunity to respond to Verizon VA's supplemental evidence had the Bureau accepted it — and to conduct discovery and cross-examination.

D. By Rejecting the FLC and Adopting a Current Cost to Book Cost Ratio, the *Order* Guarantees that Verizon VA Will Underrecover Proper Forward-Looking Expenses.

By rejecting Verizon VA's "forward-looking-to-current" conversion factor (the "FLC"), the *Order* "twice TELRIC[s]" the reductions that both Verizon VA and the *Order* itself make to the forward-looking expenses included in Verizon VA's models.[61/] As a result, Verizon VA's expenses are slashed even below what the *Order* deemed forward-looking. This reduction is due to a mathematical function of Verizon VA's studies, which the FLC is designed to address. The *Order* compounds this error by adopting a current cost to book cost ("CC/BC") ratio that effectively "triple TELRICs" expenses without justification.

Verizon VA develops its cost factors using forward-looking expenses in the numerator. The factors are a ratio comparing these forward-looking expenses to *embedded* investment. But in the cost studies — and specifically, in the compliance runs of those studies Verizon VA must now produce as a result of the *Order* — the factors are applied to the forward-looking TELRIC investment adopted by the *Order*, which is much lower than the embedded investment. As a function of simple mathematics, therefore, when the cost factors are applied to this reduced

61/ Order on Unbundled Network Element Rates, *Proceeding on Motion of the Commission to Examine New York Telephone Company's Rates for Unbundled Network Elements*, Case No. 98-C-1357, at 57 (N.Y. Pub. Serv. Comm'n Jan. 28, 2002) ("*New York UNE Order*") (quoting Recommended Decision in Module 3, *Proceeding on Motion of the Commission to Examine New York Telephone Company's Rates for Unbundled Network Elements*, Case No. 98-C-1357, 2001 N.Y. PUC LEXIS 293, at *140 (N.Y. Pub. Serv. Comm'n May 16, 2001) ("*New York Recommended Decision*")).

investment in Verizon VA's compliance runs, they will artificially understate expenses by calculating them as a percentage of this lower investment amount. Since the expenses were already adjusted to be forward-looking, this additional reduction makes no sense and has no basis in any assumed attribute of the forward-looking network; it is merely mathematical. As even AT&T/WorldCom acknowledge, the FLC corrects for this second level of reduction, ensuring that applying the annual cost factors within Verizon VA's studies produces the level of forward-looking expenses used to develop those factors. *See* AT&T/WCom Opp. at 31 (FLC produces "expenses that Verizon inputs into the numerator of the ACFs.") The FLC simply adjusts the factors to account for the new level of investment in order to preserve the identified forward-looking expenses. *See* VZ-VA Ex. 107 at 70-73.

AT&T/WorldCom's only defense of the *Order's* rejection of the FLC is to assert that Verizon VA's expenses are not sufficiently forward-looking. AT&T/WCom Opp. at 31-32. But that is a non-sequitur. It is not appropriate for AT&T/WorldCom to try to reduce expenses through the back door by removing the FLC from Verizon VA's studies. And to the extent AT&T/WorldCom had substantive arguments concerning reductions in specific expenses that should be assumed in the forward-looking network, they had the opportunity to present those arguments in the case before the Bureau. They have not sought reconsideration or review of *any* of the *Order's* determinations concerning Verizon VA's expenses, and thus must be presumed to agree that there is no valid basis to reduce particular expenses beyond what the Bureau ordered. There accordingly is no basis to indirectly reduce expenses further by simply removing the FLC.

In any event, AT&T/WorldCom's efforts to show that the expenses Verizon VA's factors would produce *with* the FLC are too high simply fail. Verizon VA's *proposed* expenses were themselves forward-looking, and on top of that, the *Order* now requires additional reductions to

Verizon VA's expenses. Thus, the expenses Verizon VA's factors — as adjusted by the FLC — will produce in the compliance runs in this case are forward-looking and are well below the embedded expenses that Verizon VA experiences today. As the Pennsylvania Commission recently recognized, that alone is reason to reject AT&T/WorldCom's attack on the FLC: "[The CLECs'] argument is not with the FLC itself but with the issue of whether Verizon's TELRIC expense levels are truly forward-looking. Our adjustments to expenses are designed to ensure that they are forward-looking and thus, would negate [the CLECs'] arguments."[62]

As noted, Verizon VA itself makes significant forward-looking adjustments to embedded expenses, and only these adjusted expenses are used in the factors. Verizon VA adjusts maintenance expenses to reflect the use of new copper and assumes productivity improvements. *See* VZ-VA Ex. 107 at 62; VZ-VA Ex. 122 at 22. AT&T/WorldCom suggest that these changes are insufficient, arguing in particular that Verizon VA's productivity factor is too limited. AT&T/WCom Opp. at 31-32. But they have never offered any concrete proposals for a different productivity factor. Based on the Bureau's baseball arbitration rules, *Order* ¶ 24, that should end the matter. AT&T/WorldCom's more generalized insistence that Verizon VA's expenses "accounted for *none* of the expected savings in expenses in a forward-looking network" arising from technology or equipment changes, AT&T/WCom Opp. at 31, likewise fails. Verizon VA's studies reflect precisely such savings: By using cost factors related to specific classes of equipment, Verizon VA ensures that its studies include only the expenses associated with the forward-looking technology mix. *See* VZ-VA Ex. 107 at 17; VZ-VA Post-Hearing Reply Brief at 47. Thus, where the forward-looking network assumes technology or equipment that is less

[62] *See* Tentative Order, *Generic Investigation Re Verizon Pennsylvania Inc.'s Unbundled Network Element Rates*, Docket No. R-00016683, at 60 (Proprietary Version) (PA P.U.C. Oct. 24, 2002) ("*Tentative Pennsylvania Order*").

expensive to maintain, such as fiber in place of copper plant, Verizon VA's models would produce more of the fiber and less of the copper maintenance expense — and thus lower *overall* maintenance expenses.

Moreover, the *Order* has required assumptions that reduce Verizon VA's expenses even further below the levels Verizon VA proposed. Specifically, the *Order* adjusted the plant mix and eliminated Verizon VA's expenses by eliminating advertising and marketing expenses. Order ¶ 145. Thus, the *Order* already determines those respects in which it found that Verizon VA's expenses were not sufficiently forward-looking, and it has made the adjustments it found to be appropriate. The resulting expenses must be treated as the level of forward-looking expense that Verizon VA has the right to recover.

As explained above, recovery of these expenses will occur *only* if the FLC is included in Verizon VA's factor development. Without the FLC, the expenses the adjusted factors will produce in Verizon VA's compliance runs will be even further reduced. The New York Commission found that this improperly "double count[s] the TELRIC" reduction.[63/] *New York UNE Order* at 58. There is no defensible basis for that result. As the Pennsylvania Commission recognized, once expenses have been reviewed and adjusted, Verizon has a right to recover the approved amounts, and using the FLC produces that result. *See Tentative Pennsylvania Order* at 60.

63/ AT&T/WorldCom try to dismiss the New York Commission's adoption of the FLC on the ground that Verizon made a larger productivity adjustment in that case. AT&T/WCom Opp. at 33. But the CLECs miss the point: the New York Commission correctly recognized that the question of appropriate forward-looking adjustments is *distinct* from the question of whether the FLC is appropriate. If the CLECs believed Verizon VA should have adopted a higher productivity factor in this case, they could have proposed one. Their failure to do so is not ground to reject the FLC.

The *Order* erred further when, in addition to rejecting the FLC, it applied a current cost to book cost ratio. That results in yet a *third* reduction to Verizon VA's expenses.[64] The *Order* cannot lawfully preclude Verizon VA from recovering even those expenses that the *Order* approved as legitimately forward-looking. The sole effort AT&T/WorldCom make to actually defend the application of the CC/BC ratio makes no sense. They correctly note that the ratio converts *embedded* investment into *current* dollars, which would make such investment more consistent with *current* expenses. ATT/WCom Opp. at 34 (emphasis added). But TELRIC is designed to measure *forward-looking* costs, not *current* expense *or* investment. Because Verizon VA uses forward-looking expenses in its factors, application of the CC/BC ratio produces a ratio of *forward-looking* expenses to *current* investment. This does not eliminate the "timing mismatch" that the CLECs identify. AT&T/WCom Opp. at 34. An adjustment is still required to make the ratio forward-looking. This would just be a restated FLC, designed to account for the difference between CC/BC-adjusted investment, and forward-looking TELRIC investment. But when the CC/BC is instead applied in *lieu of* the FLC, the resulting expenses are below the levels that would result from the technology assumptions the *Order* adopts.

III. NON-RECURRING COSTS

A. The *Order*'s Decision to Shift Most Non-Recurring Costs to Recurring Rates Is Erroneous and Creates New Subsidies for CLECs.

The *Order's* requirement that Verizon VA recover most of its non-recurring costs through recurring rates is inconsistent with established Commission policy. The Commission has specifically found that "[l]oad[ing] the unrecovered non-recurring costs into recurring rates"

---

[64] *See* VZ-VA AFR at 56. This is so because the average CC/BC ratio is greater than one, and it therefore increases the level of investment in the ACF denominator and decreases the value of the ACF. *See* id. at 61.

would be "inconsistent with the policies . . . that favor recovering costs from the cost causer," "would distort the prices paid by . . . customers," and would create a "subsidy of short-term users by longer term customers."[65]

AT&T/WorldCom's claim that their approach is consistent with Commission policy and "the Commission's definition of a recurring cost as a cost 'incurred periodically over time,'" AT&T/WCom Opp. at 81-82, is clearly wrong. Both the *Order* and AT&T/WorldCom acknowledge that the costs of "*one-time* activities . . . [are] recovered through recurring charges" in the AT&T/WorldCom model. *Order* ¶ 582; *see also* AT&T/WCom Opp. at 81 (AT&T/WorldCom model does "*not* treat all one-time costs as NRCs") (emphasis in original). Thus, AT&T/WorldCom violate the Commission's established definitions of recurring and non-recurring costs by classifying costs as recurring even though they are *not* incurred "over time" but are rather one-time costs necessary to provision individual orders.[66]

AT&T/WorldCom's argument is based on a mischaracterization of "one-time" cost. According to AT&T/WorldCom, a cost is non-recurring "*only* if it is incurred for a one-time

[65] *Non-Recurring Charges Order* at 3499 ¶ 12, 3501-02 ¶¶ 32-33, 35; Order, *MCI Telecommunications Corp. Application for Review of the Ameritech Operating Companies, Bell Atlantic Telephone Companies, BellSouth Telecommunications Inc., Cincinnati Bell Telephone Company, GTE Service Corporation, the NYNEX Telephone Companies, Pacific Bell, Rochester Telephone Corp., Southern New England Telephone Company, Southwestern Bell Telephone Company, United Telephone and Central Telephone Companies, and U S WEST Communications*, 12 FCC Rcd 16565, 16571 ¶ 12 (1997); *see also Local Competition Order* at 15874 ¶ 743.

[66] AT&T/WorldCom's claim that Verizon VA has included costs incurred over time, such as construction and maintenance, in non-recurring rates is contrary to fact. AT&T/WCom Opp. at 81. Verizon VA's cost studies recover construction and maintenance costs, as well as other costs "incurred over time," through recurring charges. Verizon Virginia Non-Recurring Cost Panel Surrebuttal Testimony at 93, 99-100 (Sept. 21, 2001) ("VZ-VA Ex. 124"). As the *Order* itself notes, "Verizon defines non-recurring costs as costs associated with the *one-time activities* necessary to process and provision competitive LECs' requests for the initiation, change, or disconnection or service, or for other one-time activities." *Order* ¶ 581 (emphasis added).

benefit (i.e., is exclusive to a particular order) and cannot be used for subsequent orders." AT&T/WCom Opp. at 81. But this confuses a one-time cost with a so-called "one-time benefit." Even if a subsequent carrier might benefit from the work done in connection with a non-recurring activity, that does not change the non-recurring character of the cost. The costs that AT&T/WorldCom shift from non-recurring to recurring rates are costs that Verizon VA incurs on a one-time basis in order to process and provision a particular order for a particular CLEC, not costs incurred over the life of the relevant facility or over the period in which the CLEC takes the UNE. Under Commission precedent, such one-time costs should be recovered through a non-recurring charge, and the CLEC, not Verizon VA, should bear the risk that there might *not* be future benefits from that service, since it is the CLEC that enjoys the *current* benefit and imposes the upfront cost.[67]

In any event, AT&T/WorldCom's argument fails to explain the shifting of numerous non-recurring costs into recurring rates in AT&T/WorldCom's model. The only example AT&T/WorldCom provide of a non-recurring activity that might benefit subsequent carriers is the placement of a cross-connect at the feeder-distribution interface. AT&T/WCom Opp. at 81 n.79; *see also Order* ¶¶ 569, 584. But Verizon's model includes *83* other additional non-recurring costs not identified in AT&T/WorldCom's model. *Id.* ¶¶ 581-82. These other missing 83 costs do not all relate to benefits that subsequent carriers might reuse, and thus, even under AT&T/WorldCom's approach, should be recovered through non-recurring rates. Indeed, AT&T/WorldCom fail to include *any* non-recurring costs at all for a large number of UNEs,

[67] Although AT&T/WorldCom point to language in prior rulemaking orders where the Commission has permitted shifting of non-recurring costs to recurring rates in *limited* circumstances, AT&T/WCom Opp. at 84-85, their model would make recovery of non-recurring costs through non-recurring rates the *exception* rather than the rule — the exact opposite of what Commission precedent and economic principles require.

including subloops, many types of ports, multiplexing, and others. AT&T/WorldCom did not even try to show that all these other costs are for activities that will benefit subsequent carriers, nor could they.

AT&T/WorldCom also incorrectly assert that Verizon VA "effectively acknowledged" that many of the non-recurring costs in its model are currently recovered through recurring charges. AT&T/WCom Opp. at 82. The *Order* and AT&T/WorldCom cite to the fact that Verizon VA backs out non-recurring revenues from the accounts used to calculate its annual cost factors as evidence that non-recurring costs are included in both Verizon's non-recurring and recurring cost studies. But Verizon VA makes this adjustment because it records both recurring and non-recurring revenues associated with particular UNEs to the same accounts. Thus, this adjustment is needed to ensure that those costs it treats as recurring when it develops its annual cost factors do not inadvertently include (and hence double recover) costs that are properly treated as non-recurring. How Verizon VA books revenues is simply irrelevant to whether those revenues recover recurring or non-recurring costs.

Furthermore, the *Order*'s adoption of AT&T/WorldCom's classification of recurring and non-recurring charges also fails to address the increased risks to Verizon VA because it must underwrite the risk of CLECs' entry to the market. *See* VZ-VA AFR at 64. The *Order* requires Verizon VA to act as the CLECs' banker, extending credit to CLECs for immediate cash outlays that Verizon VA will recover over time, if at all. The result is to create a substantial risk of underrecovery since, as the *Order* acknowledges, estimates about how long the average customer will take service are inevitably uncertain. *See Order* ¶ 597. But, the Commission has clearly stated that "LECs should not be forced to underwrite the risk" of CLECs' entry.[68] Moreover, the effect of the *Order* is to create a subsidy flowing from Verizon and other long-term users of the network to the CLECs. Such a subsidy is contrary to Commission policy. *Non-Recurring Charges Order* at 3501-02 ¶¶ 32-33.

AT&T/WorldCom do not deny this effect. Instead, they argue that Verizon VA should not be concerned about this risk because "'the risk of non-collection only exists if the competitive LEC exits the market'" and the uncollectibles markup Verizon VA makes to its UNE prices addresses this loss. AT&T/WCom Opp. at 86 (quoting *Order* ¶ 598). But AT&T/WorldCom's argument misses the mark. First, as discussed above, the .56% uncollectible rate approved by the *Order* does not come close to covering even Verizon VA's *current* wholesale uncollectible expenses; it certainly does not and could not cover the new and additional risk created by shifting most non-recurring costs to recurring rates.

Second, Verizon's risk of non-collection, while substantial, represents only a portion of Verizon VA's risk of non-recovery. The purpose of the uncollectible portion of Verizon VA's gross revenue loading is to recover money that Verizon VA has billed but has been unable to collect; it does not, and is not designed to, account for the risk that Verizon will not recover its costs as a result of ordinary customer churn. Thus, for example, if Verizon is forced to incur the non-recurring costs of establishing service for a WorldCom customer, and then that customer terminates service after three months — as WorldCom has stated 50% of its customers do, *Triennial Review Order* ¶ 471 — WorldCom would have made only three months worth of installment payments for the non-recurring cost it caused. The remaining unrecovered costs for

[68] Second Report and Order, *Local Exchange Carriers' Rates, Terms, and Conditions for Expanded Interconnection through Physical Collocation for Special Access and Switched Transport*, 12 FCC Rcd 18730, 18750 ¶ 33 (1997).

the non-recurring activities Verizon VA undertook would not be "uncollectibles," because WorldCom would not *owe* Verizon anything under the system set up by the *Order*. Yet Verizon VA would have no way to recover those costs.

B. AT&T/WorldCom's Model Improperly Excludes Non-Recurring Costs and Is Based on an Erroneous Interpretation of TELRIC's Requirement that Costs Be Based on "Currently Available" Technology.

In addition to improperly shifting most non-recurring costs to recurring rates, the *Order*'s decision to adopt the AT&T/WorldCom non-recurring cost model violates Commission policy by failing to compensate Verizon VA for the out-of-pocket non-recurring costs it will incur to provision UNEs. The Commission has consistently recognized that "LECs should . . . recover through an NRC their full one-time costs of providing, terminating or modifying a[] . . . service. This is consistent with our policies encouraging the recovery of costs from cost causers and would reduce the subsidy of short-term users by longer term customers." *Non-Recurring Charges Order* at 3501-02 ¶¶ 32-33. Thus, the Commission has found that CLECs are "required to bear the cost" of "modifications to incumbent LEC facilities to the extent necessary to accommodate interconnection or access to network elements," *Local Competition Order* at 15602-03 ¶¶ 198-99, and has expressly rejected interpretations of TELRIC that assume away costs, such as loop conditioning, that would not be incurred in a hypothetical network, but unquestionably must be performed in the real world.[69]

---

[69] *Local Competition Order* at 15692 ¶ 382; Third Report and Order and Fourth Further Notice of Proposed Rulemaking, *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, 15 FCC Rcd 3696, 3784 ¶ 193 (1999); FCC Reply Br. at 10 n.7 ("[The] [] suggestion . . . that TELRIC authorizes regulators to require incumbents to modify, 'for free,' loops to facilitate certain advanced services ignores express FCC directions to the contrary.") (citations omitted).

AT&T/WorldCom's argument that their model "neither understates nor ignores non-recurring costs," AT&T/WCom Opp. at 86, is belied by their admission, in the following sentence, that "the *Order* found that [AT&T/WorldCom's model] should have included certain activities that the *Order* agreed should be recovered on a non-recurring basis," *id.* at 87. Indeed, the *Order* explicitly found that the AT&T/WorldCom model failed to produce costs for activities that the Bureau found are legitimate non-recurring activities, including design time, loop conditioning, and line sharing. *Id.* ¶¶ 618, 639, 642, 648. The fact that AT&T/WorldCom's model does not include such costs demonstrates the inadequacy of its underlying assumptions and overall approach. The baseball arbitration rules required the *Order* to use Verizon VA's model not only for the missing elements, but for all non-recurring costs, because it was the only model in the record that modeled the non-recurring costs that even the *Order* agreed should be recovered through non-recurring rates. Moreover, the *Order*'s decision to permit AT&T/WorldCom to introduce new evidence to calculate the missing non-recurring costs was both unlawful and unfair. The *Order* instead should have used Verizon VA's studies. *See, e.g.*, *Order* ¶ 554.

AT&T/WorldCom's argument that it was proper for the *Order* to allow them to introduce entirely new evidence concerning the costs missing from its model is hypocritical. AT&T/WorldCom opposed Verizon VA's motion to reopen the record, and defend the *Order*'s denial of Verizon VA's motion, on the grounds that it would be unfair to allow Verizon VA to introduce new evidence without the benefit of cross examination or discovery. AT&T/WCom Opp. at 37. Yet that is precisely the effect of the *Order*'s decision to permit AT&T/WorldCom to introduce new evidence even after the decision was issued. While AT&T/WorldCom suggest that "the *Order*'s procedures provide Verizon with the information it will need to verify the accuracy of the calculations," AT&T/WCom Opp. at 89 n.103, that clearly is untrue. Verizon VA will not have the opportunity to obtain discovery or cross-examine AT&T/WorldCom on the numbers it produces, and thus will have no way of testing the assumptions that underlie AT&T's numbers. That is particularly egregious since AT&T/WorldCom's "model" is nothing more than the collected opinion of a few subject matter experts, and accordingly there is no way to "verify" *any* of its results or calculations.

The *Order* also denies Verizon VA recovery of its out-of-pocket costs because even those "rates that AT&T/WorldCom's model produces are based on extreme hypothetical assumptions that drive rates down well below cost." VZ-VA AFR at 69. AT&T/WorldCom's defense of the technologies they assume in their model rests on a fundamentally flawed interpretation of TELRIC that deems technology to be "currently available" as long as it is theoretically "technically feasible" to develop at some future point. AT&T/WCom Opp. at 90. But the Commission made clear in the *Triennial Review Order* that any technology assumed for TELRIC purposes must be actually deployed and capable of performing the relevant function in at least *some* carrier's network, and may not be technology that theoretically "may be available in the future." *Triennial Review Order* ¶ 670 n.2020. In other words, TELRIC requires that the ILEC must actually be able to purchase the particular technology assumed in the cost study, not merely that it might be feasible at some point in the future.

Notwithstanding the Commission's rules, AT&T/WorldCom's model assumes technology that even they admit *no* carrier has deployed. *See* VA-VZ Ex. 122, Attachment A (AT&T/WCom Response to VZ-VA VII-26); *see also* Tr. at 4619 (Riolo). It is undisputed that, for example, *no* carrier can or has deployed OSS that enable it to process orders automatically with only 2% fallout.[70] Verizon Virginia Non-Recurring Cost Panel Rebuttal Testimony at 13-22 (Aug. 27, 2001) ("VZ-VA Ex. 116"). These assumptions violate the Commission's TELRIC principles and result in unrealistic and understated non-recurring costs.

AT&T/WorldCom attempt to defend their assumption based on a misstatement of Verizon's position. AT&T/WorldCom assert that "Verizon's criticism is based on its view that only the technology that *it* intends to provide in the future is 'currently available.'" AT&T/WCom Opp. at 90. But Verizon VA imposed no such limitation in modeling non-recurring costs. Indeed, AT&T/WorldCom are unable to point to any "currently available" technology (as opposed to the hypothetical technologies they assume in their model) that Verizon VA's model excludes.

Finally, as Verizon VA explained, AT&T/WorldCom's model is also flawed because it is based "solely on the subjective opinion of [AT&T's] subject matter experts." *Order* ¶ 571. AT&T/WorldCom's rejoinder that Verizon VA also used subject matter experts, AT&T/WCom Opp. at 90, misses the point. As discussed below, Verizon VA's model was also based on extensive survey and statistical analysis. AT&T/WorldCom's model, on the other hand, lacks any such empirical grounding. And, while AT&T/WorldCom assert that their so-called experts had "many years of experience working for ILECs," *id.* at 91, they admittedly had *no* experience in processing wholesale UNE orders or provisioning UNEs. Tr. at 4650-54. (Walsh) Verizon

---

70/ AT&T/WorldCom claim that the 2% figure consists only of orders that fallout due to CLEC error. AT&T/WCom Opp. at 89. But AT&T/WorldCom provided no more support for a 2% CLEC-caused fallout rate than they did for a 2% overall fallout rate. In any event, TELRIC requires that ILECs be compensated for the costs they will actually incur to process CLEC orders given currently available technology, including any necessary manual handling, even if that fallout is not the result of CLEC "error."

VA's experts, on the other hand, have extensive experience in the relevant processes for providing UNEs to CLECs. VZ-VA Ex. 107 at 317.

C. Verizon VA's Non-Recurring Cost Model Appropriately Models Costs for the One-Time Activities Verizon VA Will Perform to Provision CLECs' Orders.

The *Order*'s decision to reject Verizon VA's model also should be reversed. *First,* as the *Order* finds, Verizon provides "*more* support" for its time and frequency estimates than does AT&T/WorldCom, whose model is based "solely" on subjective opinion. *Order* ¶¶ 571-72 (emphasis added). Indeed, after extensive review, the New York Commission determined that Verizon's work times were well supported and statistically valid. *See New York Recommended Decision* at *188. Verizon VA's studies begin with an extensive survey of its workers with real-world experience to determine how long a particular task currently takes and the frequency with which it is performed. After the survey results were validated by a statistician, subject matter experts made forward-looking adjustments to the resulting time and frequencies where currently available technologies would enable those tasks to be performed more efficiently.[71] VZ-VA Ex. 107 at 311, 316-17. An outside consultant then reviewed the statistical precision of Verizon VA's non-recurring cost estimates and calculated that, for all but a few UNEs, there was a 95% probability that Verizon's non-recurring cost estimates were within 15% of the actual cost Verizon VA will incur to perform the relevant task. *Id.* at 325.

71/ As Verizon VA explained in its application for review, Andersen Consulting validated the order processing times. AT&T/WorldCom note that Andersen Consulting subsequently performed its own study of work times for order processing. AT&T/WCom Opp. at 93 n.110. Verizon VA submitted that study, and the *Order* admits it into the record. *Order* ¶ 14. That study — performed by an objective third-party — clearly is a more appropriate basis for determining non-recurring costs for order processing than AT&T/WorldCom's wholly subjective model.

Second, Verizon has already demonstrated that the "methodological errors" AT&T/WorldCom cite, AT&T/WCom Opp. at 92, are unfounded. For example, concerns that employees might have overstated the times for completing activities are incorrect. As Verizon explained, the instructions to the survey respondents explicitly stressed that the results of the process needed to be "accurate and credible." Tr. at 4694. Indeed, as Verizon VA's statistical expert, Mr. Gene Goldrick, observed, workers may have had an incentive to *understate* the time it takes them to perform tasks out of "fear that [high work time estimates] might come back . . . and identify or tag [the worker] as an unproductive individual." Tr. at 4715-16. Similarly, there is no reason to believe that weighting the responses to account for the number of times the respondent performed the tasks, even if possible, would have reduced work times. To the contrary, if longer work times were more frequent, weighting may well have increased work times. Tr. at 4706 (Goldrick). Nor do variations in the survey data do not undermine the results. Many tasks included in Verizon VA's model are open-ended activities for which one would expect to observe even significant variation in respondents' estimates. Workers' average experiences and average work times will differ due to the types of orders they process, the environments in which they work (*e.g.*, rural versus urban), and their differing skills or experiences. *See* VZ-VA Ex. 124 at 32-35.

AT&T/WorldCom are also incorrect that Verizon VA determined NRCs "based on its own embedded network." AT&T/WCom Opp. at 91. Verizon uses the existing network to determine current work times. Those current times, in turn, serve as a starting point for determining *forward-looking* costs. Verizon makes a variety of forward-looking adjustments that reduce work times and the frequency with which tasks must be done, adjustments that reduce costs and reflect a forward-looking environment. *See, e.g.*, VZ-VA Ex. 107 at 303-05;

VZ-VA Ex. 124 at 11-24, 26. Thus, Verizon VA's non-recurring cost model produces costs below its current real-world experience.

Third, AT&T/WorldCom acknowledge that a number of state commission decisions have relied on Verizon's non-recurring cost model but attempt to minimize that fact by asserting that the state commissions made adjustments to that model. AT&T/WCom Opp. at 94-95. As an initial matter, none of those adjustments resulted in non-recurring rates nearly as far below costs as those that result from AT&T/WorldCom's model. Moreover, those adjustments do not undermine the fact that these state commissions have determined that Verizon's model is an appropriate starting point for determining non-recurring costs.[72] The Bureau here could have made similar adjustments to the extent it properly determined that they were warranted. That approach certainly would have been far more consistent with TELRIC than the adoption of

---

[72] *See New York Recommended Decision* at *186-88; *see also* Order No. 78552, *In the Matter of the Investigation Into Rates for Unbundled Network Elements Pursuant to the Telecommunications Act of 1996*, Case No. 8879, Public Service Commission of Maryland, 87-88 (June 20, 2003) ("*Maryland UNE Order*"); Decision and Order, *In the Matter of the Board's Review of Unbundled Network Element Rates, Terms and Conditions of Bell Atlantic-New Jersey, Inc.*, Docket No. TO-00060356, at 157-67 (N.J. Bd. Pub. Util. Mar. 6, 2002) ("*New Jersey UNE Order*"); Order, *Investigation by the Department of Telecommunications and Energy on Its Own Motion into the Appropriate Pricing, Based Upon Total Element Long-Run Incremental Costs, for Unbundled Network Elements and Combinations of Unbundled Network Elements, and the Appropriate Avoided-Cost Discount for Verizon New England, Inc. d/b/a Verizon Massachusetts Resale Services in the Commonwealth of Massachusetts*, Docket No. D.T.E. 01-20, MA Dep't of Telecommunications and Energy, 432-500 (July 11, 2002) ("*Massachusetts UNE Order*"); Findings, Opinion and Order No. 5967, *Application of Verizon Delaware, Inc. (F/K/A Bell Atlantic-Delaware, Inc.), for Approval of Its Statement of Terms and Conditions Under § 252(f) of the Telecommunications Act of 1996*, Docket No. 96-324 Phase II, at 31-35 (Del. Pub. Serv. Comm'n June 4, 2002) ("*Delaware UNE Order*"); Report and Order, *Review of Bell Atlantic-Rhode Island TELRIC Study*, Docket No. 2681, at 62-69 (R.I. Pub. Util. Comm'n Nov. 18, 2001) ("*Rhode Island UNE Order*").

AT&T/WorldCom's model, which is contrary to Commission policy and fails to capture many of Verizon VA's non-recurring costs *at all*.[73]

IV. THE COMMISSION MUST EVALUATE THE CONFISCATORY EFFECT OF THE ORDER BEFORE IT IS ALLOWED TO TAKE EFFECT.

In its application for review, Verizon VA demonstrated that the UNE rates adopted by the *Order* will be confiscatory because they will not permit Verizon VA to recover its unrecovered prudent investment in facilities used and useful in providing wholesale service, or to recover the actual operating costs and forward-looking investment costs that Verizon VA will necessarily incur to provide those facilities. The Commission is obligated to evaluate whether the UNE rates are confiscatory before they become effective and to provide a mechanism to compensate Verizon VA for any shortfall. *See* VZ-VA AFR at 72-77. None of AT&T/WorldCom's arguments undermines this showing.

A. The Constitutional Standard for Evaluating the Confiscatory Effect of Rates Is Recovery of Costs Necessarily Incurred by Verizon VA, Including Past Prudent Investment.

UNE rates are confiscatory if they fail to enable Verizon VA to recover the costs that it necessarily incurs to provide UNEs, including Verizon VA's past prudent investment. Even in the traditional regulatory takings context, where a utility has voluntarily committed its plant to serving the public, the courts have recognized that the utility is entitled to recover "the capital

---

[73] AT&T/WorldCom's attempt to discount the Commission's approval of Verizon's 271 applications in many states where non-recurring rates were based on Verizon's model similarly fails. While AT&T/WorldCom assert that the Commission seeks only to determine whether rates fall outside of a range that "a reasonable application of TELRIC principles would produce," *see* AT&T/WCom Opp. at 94, the fact is that the rates produced by AT&T/WorldCom's model are so low (or non-existent) that they cannot be in the same "reasonable range" as those produced by Verizon's model.